GLOBAL
Insight
WEEKLY

Perspectives from the Global Portfolio Advisory Committee

January 11, 2024

The downside of up

Thomas Garretson, CFA – Minneapolis

Global bonds are coming off one of their best performances in decades as expectations swelled late last year that central banks could soon pivot to rate cuts. But could a reacceleration in inflation put that narrative in jeopardy to start the new year?

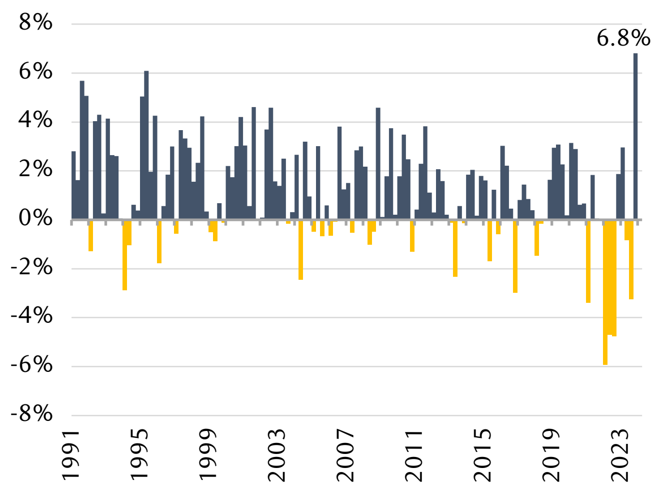
The Q4 2023 rally in seemingly everything caught most investors off guard, particularly in fixed income markets. The U.S. 10-year Treasury yield peaked near 5.0 percent on Oct. 19, only to fall to around 3.9 percent by the close of 2023. A drop of that magnitude over such a short timespan has only been seen about five times dating back to 1990. And it is a similar story globally as the German 10-year Bund yield ascended to a decade high of nearly 3.0 percent in October, only to drop back below 2.0 percent by year end. The decline in sovereign bond yields helped to fuel a well-publicized rally in risk assets, with most major global stock indexes also posting historically strong rallies.

All of which was largely predicated on the idea that not only have central banks well and truly reached peak policy rate levels, but that greater progress on inflation than markets expected could cause banks to pivot to modest rate cuts, and perhaps sooner than many market participants had anticipated.

As is usually the case, the path forward for central bank policy rates and sovereign bond yields will likely dictate the trajectory of asset class returns this year, and therein lies the near-term risk—did bond markets run too far, too fast?

Bloomberg US Aggregate Bond Index posts a quarter for the record books

Quarterly total returns



Source - RBC Wealth Management, Bloomberg; quarterly data through Dec. 2023

A thief in the night

In our Global Insight 2024 Outlook, we projected a base case of low double-digit returns for most U.S. bond sectors, with the potential for even greater returns should the benchmark 10-year Treasury yield fade below 4.0 percent by year end.

Unfortunately, Q4 of last year perhaps robbed 2024 of some of those returns. As the chart shows, the Bloomberg U.S. Aggregate Bond Index advanced by 6.8 percent as yields fell, the best quarterly performance in at least

For perspectives on the week from our regional analysts, please see pages 3–4.

30 years. Bond prices, which move inversely to yields, jumped as a result. The average bond price in the index bounced from $86 to $92 over the course of Q4.

In the U.S., while the Federal Reserve projected three 25 basis point rate cuts this year to an implied target range of 4.50 percent to 4.75 percent at its December policy meeting, the market is currently priced for significantly more cuts down to an implied target range of 3.75 percent to 4.00 percent by year end, with a first cut potentially by the March meeting—though that is not yet our base case.

Given the current divergence between Fed and market rate cut expectations, broad volatility will likely remain elevated as each key piece of economic data could spark market swings one way or the other as traders gauge both the timing and extent of central bank rate cuts this year.

Bond strategy

Despite the recent run in bond market performance, we still expect healthy returns in 2024 for bonds. However, we would turn slightly cautious over the near term. While we strongly favored a strategy of swapping cash and short-dated securities in favor of longer-dated bonds in the back half of 2023 in order to lock in historically high yields, cash or money market funds which still offer annualized yields north of 5.0 percent could be a worthwhile parking spot on a tactical basis in anticipation of more attractive entry points into longer-dated bonds. Of course, investors need to be cognizant of the fact that those short-term yields will begin to fade if and when the Fed embarks on a rate cut journey.

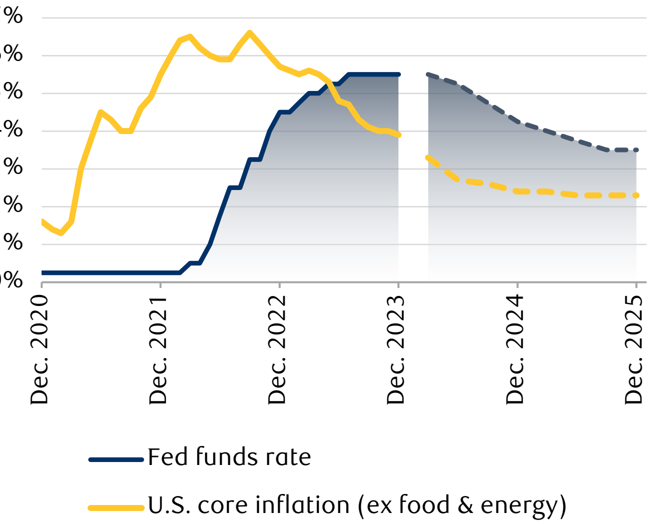
In framing the near-term outlook, we focus on the benchmark U.S. 10-year Treasury yield. Currently around 4.0 percent, we view approximately 4.3 percent as a potential ceiling and where we would look to put money to work should the market dial back rate cut expectations. On the downside, we see a floor for the 10-year around 3.50 percent this year.

Economic and market optimism has pushed valuations in U.S. municipal and corporate bond markets to historically rich levels relative to comparable Treasuries. Therefore, we would also take a cautious approach for the time being to those sectors.

Not much of a wake-up call

The first reality check for markets in 2024 was this week's U.S. Consumer Price Index report. On the surface, inflationary pressures rose more than Bloomberg consensus estimates had expected, but the market reaction was relatively muted regardless. As Fed Chair Jerome Powell has often stated, the path back to two percent annual inflation was always going to be a bumpy one, and the inflation data for December was perhaps one of the bumpy ones as headline inflation rose to 3.4 percent year over year, up from 3.2 percent annually in November—though core prices (excluding food and energy) fell to another low of 3.9 percent annually.

"Normalization" of inflation should drive a "normalization" of policy rates



Source - RBC Wealth Management, Bloomberg; dashed lines show RBC Capital Markets quarterly forecasts

Despite a slight uptick in inflation, real wages—adjusted for inflation—were shown to have increased by 0.8 percent over the past year, marking the eighth month running that incomes have outpaced inflation. As a result, consumers remain in a strong position to consume, which likely caused RBC Economics to boost its near-term economic outlook for the U.S., seeing Q1 GDP growth as being flat, up from minus 1.0 percent previously, with the U.S. economy seen as now likely to avoid a recession again this year.

Everything in moderation

Of course, with the unemployment rate still well below four percent and inflation north of the Fed's two percent target, it may be natural to ask why the market is even entertaining the idea of multiple rate cuts, let alone any rate cuts.

As the chart shows, it simply comes down to policy calibration. Despite an uptick in inflation last month, the trend of lower inflation is likely to remain in place as RBC Capital Markets still expects further declines this year, along with comparable reductions in the Fed's policy rate.

The gap between the Fed's policy rate and the rate of inflation is the "real" rate, and that's the rate which has actual implications for the economy, in our view. The main point being that even if the Fed cuts rates multiple times this year, monetary policy may not actually be easing, but simply remaining steady and therefore not risking undue economic damage, in our view, should real policy rates rise too far, and for too long.

All told, we still see rate cuts on the horizon, but the road there likely won't be without some bumps, with bond markets potentially being a near-term source of broader market volatility.

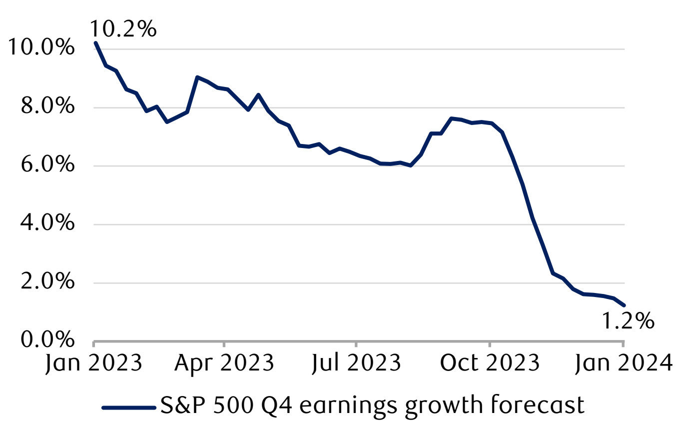
UNITED STATES

Tyler Frawley, CFA – Minneapolis

- **U.S. equities are higher on the week as investors look ahead to the Q4 earnings season that kicks off Friday.** All major indexes are higher, with the Nasdaq's 3.09% return making it the best relative performer. The S&P 500 is up 1.78%, outperforming the Dow Jones Industrial Average, up 0.63%. Leadership is seen in Information Technology, up 4.47%, as the sector rebounds after a difficult start to 2024 last week. Energy has been the worst-performing sector, falling 3.66%, as oil prices have moved lower following price cuts from Saudi Arabia—mostly attributed to record U.S. production and softening demand in China.

- **Earnings growth estimates for Q4 2023 continue to move lower**. As Q4 earnings season is set to begin with JPMorgan Chase, Wall Street analysts have been cutting their growth expectations for the S&P 500; year-over-year growth is now expected to be just 1.2%, according to Bloomberg. This is down sharply from the start of 2023, when expectations peaked at 10.2% in early January. For most of last year, Q4 2023 growth expectations hovered in the 6%–8% range, but they have moved sharply lower since the beginning of October following weaker-than-expected guidance during the Q3 earnings period. At a sector level, Health Care (-21.3%) and Materials (-13.5%) saw the largest decreases in their EPS estimates during the quarter. Utilities and Information Technology, on the other hand, saw their EPS estimates increase by 1.9% and 1.2%, respectively. While other earnings data providers show slightly higher S&P 500 Q4 earnings growth estimates, they too have indicated larger-than-normal declines in consensus forecasts recently, with similar sector revision trends. As we look ahead, it will be important to monitor upcoming Q4 results, as we believe this earnings season will be an important test of investors' belief that the economy will be able to avoid a recession and achieve a soft landing as inflation continues to move lower.

S&P 500 Q4 earnings estimates move lower



Note: Forecast is based on year-over-year growth

Source - RBC Wealth Management, Bloomberg; data through 1/10/24

- **U.S. inflation was higher than expected in December**. According to the Department of Labor, headline inflation measured by the Consumer Price Index in December was 3.4%, above the Bloomberg consensus expectation of 3.2% and up from 3.1% in November. Similarly, core inflation (which excludes volatile food and energy prices) came in at 3.9%, slightly above the 3.8% consensus but down from 4.0% in November. Much of the increase can be attributed to shelter costs, which saw a 6.2% increase that represented about two-thirds of the overall rise in inflation on a year-over-year basis.

CANADA

Matt Altro & Richard Tan, CFA – Toronto

- The combination of rising interest rates, growing credit risks, elevated expenses, and the need to boost capital levels resulted in a challenging operating environment for the diversified Canadian banks in 2023. **Looking through 2024, RBC Capital Markets believes a normalization in expense growth will allow the banks to drive positive operating leverage (i.e., revenues growing faster than costs)**. Additionally, further improvement in capital ratios should create optionality for the banks to repurchase shares and support the possible elimination of discounts related to dividend reinvestment programs (i.e., shareholders may have to buy shares at market price). Finally, we believe the banks will continue to build loan-loss reserves due to the maturing business cycle, offset slightly by prospects of declining interest rates (i.e., potential for lower credit risk). Overall, we believe the bar has been effectively reset for the new year, and a return expectation of approximately 10% in 2024 for the diversified Canadian banks is reasonable, supported by average dividend yields of 5% and earnings growth of about 5%, according to RBC Capital Markets estimates.

- **The housing market continues to be a point of conversation for Canadians** as prices and activity are eagerly watched. RBC Economics reports that mortgage rate increases and a modest appreciation in home prices drove up RBC's aggregate affordability measure of ownership costs as a percentage of household income by 280 basis points to 62.5%. (The higher the measure, the worse the unaffordability.) When looking at major cities, **Vancouver and Toronto continue to be the least affordable, with the share of income a typical household would need to cover ownership costs being 102.6% and 84.1%, respectively**. The light on the horizon remains the possibility that Canadians could see rate cuts later this year, which would help ease home ownership costs but could still leave those that are most budget-constrained looking for more relief.

EUROPE

Thomas McGarrity, CFA – London

- **In recent months, a broad range of euro area economic indicators have shown signs of bottoming**. This trend continued during the week, with surveys pointing to confidence amongst both investors and consumers continuing to improve, albeit from very weak levels.

- **The Sentix Economic Index, which measures investors' optimism, rose for the third consecutive month**, while the European Commission's confidence surveys showed an improvement in consumer sentiment at the end of 2023 to its highest level since February 2022. Elsewhere, data underlined the resilience of the labour market, with the euro area unemployment rate back to its lowest level on record, at 6.4% in November.

- **Recent data naturally raises the question: Is the worst behind the euro area economy?** Ultimately, it is too early to say conclusively. Nonetheless, we think the stabilisation of recent data is encouraging, pointing to euro area activity not deteriorating further. We remain watchful for further green shoots and signs the euro area's relative economic growth momentum may be improving.

- **RBC Capital Markets continues to think Q4 growth is likely to be softer than the 0.1% q/q expansion projected by the European Central Bank** (ECB) in its December staff forecasts. Instead, it looks for a modest 0.1% q/q contraction, in line with consensus expectations, which would mark a shallow "technical recession." RBC Capital Markets remains sanguine about this, however, and forecasts economic activity to modestly strengthen as 2024 progresses, aided by a recovery in household consumption as real incomes reverse some of the declines seen over the past two years.

- **The stabilization and small uptick of leading economic indicators has provided some fundamental fuel** to the recent rally in European equities, especially cyclicals, which have notably outperformed defensives in recent months. While we advocate a relatively balanced exposure to European equities, we would seek to take some profit in cyclicals given their recent strong rally and look to add to defensives that have lagged. Ultimately, we believe now is not the time to be anchored to a particular macro thesis playing out in the year ahead. Rather, we think investors should focus on Europe's global leaders with idiosyncratic structural growth drivers.

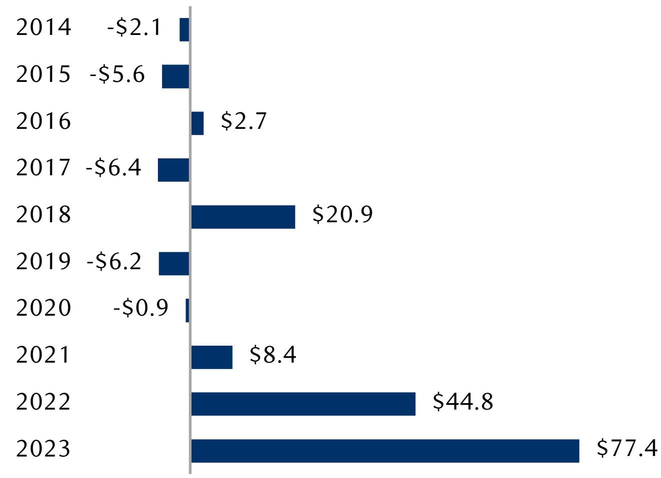
ASIA PACIFIC

Emily Li – Hong Kong

- **In the midst of last year's stock market downturn, China exchange-traded funds (ETFs) experienced an unprecedented surge in investor interest while actively managed products lost favor**, indicating a shift in investor preferences. According to data compiled by Bloomberg, stock ETFs saw a record-breaking inflow of US$77.4 billion in 2023, accompanied by the introduction of 161 new ETFs. This starkly contrasts with the minimal amount raised by new mutual funds, which hit a 10-year low in 2023 as retail investors became disenchanted with the underwhelming performance of professional stock pickers.

China onshore ETF annual net inflows

U.S. dollars (in billions)



Source - RBC Wealth Management, Bloomberg; data through 2023

- **Samsung Electronics Co. (005930 KRX) said it expected to report a decline in operating profit for the sixth consecutive quarter**, and attributed the decline to subdued consumer demand and uncertainties surrounding the timing of a broader technological recovery. South Korea's largest company reported a 35% decrease in operating income, which came in approximately 24% short of expectations. These results highlight the persistently sluggish demand for smartphones, as well as for the memory chips that are crucial components of modern electronic devices, in light of ongoing economic uncertainties. The Lee family, the driving force behind the Samsung conglomerate, recently sold approximately US$2 billion worth of shares in four companies listed in Seoul. Nearly 30 million shares of Samsung Electronics Co. were sold at a discount of 1.2% compared to the closing price on Wednesday.

- **The competition to secure bank deposits in Hong Kong is intensifying as financial institutions offer incentives to attract new funds**, taking advantage of interest rates that are at their highest levels in over a decade. In their efforts to attract fresh deposits, some banks are offering annual interest rates as high as 5% for term deposits, along with additional benefits such as air miles and fee waivers. This strategy aims to entice customers to deposit funds now, anticipating a potential decrease in interest rates later in the year.

MARKET Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,783.45	0.3%	0.3%	22.1%	2.4%
Dow Industrials (DJIA)	37,695.73	0.0%	0.0%	11.8%	4.5%
Nasdaq	14,969.65	-0.3%	-0.3%	39.3%	0.2%
Russell 2000	1,970.26	-2.8%	-2.8%	8.1%	-9.3%
S&P/TSX Comp	20,989.42	0.1%	0.1%	5.5%	-0.4%
FTSE All-Share	4,180.83	-1.2%	-1.2%	-0.6%	-0.9%
STOXX Europe 600	476.42	-0.5%	-0.5%	6.9%	-0.5%
EURO STOXX 50	4,468.98	-1.2%	-1.2%	10.1%	5.4%
Hang Seng	16,097.28	-5.6%	-5.6%	-24.5%	-32.2%
Shanghai Comp	2,877.70	-3.3%	-3.3%	-9.2%	-19.9%
Nikkei 225	34,441.72	2.9%	2.9%	31.6%	20.9%
India Sensex	71,657.71	-0.8%	-0.8%	19.2%	18.6%
Singapore Straits Times	3,179.96	-1.9%	-1.9%	-2.5%	-1.5%
Brazil Ibovespa	130,841.09	-2.5%	-2.5%	18.1%	28.3%
Mexican Bolsa IPC	55,318.67	-3.6%	-3.6%	5.7%	4.7%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.030%	15.1	15.1	41.1	227.0
Canada 10-Yr	3.270%	16.0	16.0	15.6	155.7
UK 10-Yr	3.819%	28.2	28.2	26.2	262.9
Germany 10-Yr	2.212%	18.8	18.8	-9.6	224.6
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.67%	-0.9%	-0.9%	2.8%	-7.5%
U.S. Investment-Grade Corp	5.21%	-1.0%	-1.0%	5.3%	-7.6%
U.S. High-Yield Corp	7.85%	-0.7%	-0.7%	9.6%	1.3%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	2,023.93	-1.9%	-1.9%	7.8%	12.3%
Silver (spot $/oz)	22.88	-3.8%	-3.8%	-3.1%	1.8%
Copper ($/metric ton)	8,263.40	-2.4%	-2.4%	-7.1%	-13.7%
Oil (WTI spot/bbl)	71.37	-0.4%	-0.4%	-5.0%	-8.8%
Oil (Brent spot/bbl)	76.78	-0.3%	-0.3%	-4.1%	-5.1%
Natural Gas ($/mmBtu)	3.03	20.6%	20.6%	-16.7%	-25.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	102.3570	1.0%	1.0%	-0.9%	6.6%
CAD/USD	0.7474	-1.0%	-1.0%	0.3%	-5.3%
USD/CAD	1.3380	1.0%	1.0%	-0.3%	5.5%
EUR/USD	1.0972	-0.6%	-0.6%	2.2%	-3.1%
GBP/USD	1.2741	0.1%	0.1%	4.8%	-6.2%
AUD/USD	0.6699	-1.7%	-1.7%	-2.8%	-6.6%
USD/JPY	145.7700	3.4%	3.4%	10.2%	26.5%
EUR/JPY	159.9300	2.7%	2.7%	12.7%	22.6%
EUR/GBP	0.8611	-0.7%	-0.7%	-2.5%	3.2%
EUR/CHF	0.9337	0.5%	0.5%	-5.7%	-11.1%
USD/SGD	1.3317	0.9%	0.9%	0.0%	-1.8%
USD/CNY	7.1727	1.0%	1.0%	5.8%	12.5%
USD/MXN	16.9719	0.0%	0.0%	-11.0%	-16.7%
USD/BRL	4.8930	0.7%	0.7%	-6.0%	-13.7%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Tuesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -1.0% return means the Canadian dollar fell 1.0% vs. the U.S. dollar year to date. USD/JPY 145.77 means 1 U.S. dollar will buy 145.77 yen. USD/JPY 3.4% return means the U.S. dollar rose 3.4% vs. the yen year to date.

Source - Bloomberg; data as of 1/10/24

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As of December 31, 2023

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Hold [Sector Perform]	575	39.66	154	26.78
Sell [Underperform]	46	3.17	6	13.04

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